No. 17046

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

CAL-NEVA LODGE, INC., a Nevada corporation,

*Appellant,*

*vs.*

UNITED STATES OF AMERICA,

*Appellee.*

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## REPLY BRIEF OF APPELLANT CAL-NEVA LODGE, INC.

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## REPLY BRIEF OF APPELLANT CAL-NEVA LODGE, INC.

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### I.

### Appellant Was Not in Possession of Any Property or Rights to Property of the Tax Debtor as of June 1, 1953, the Date of Levy.

"The threshhold question, in this case, as in all cases where the Federal Government asserts its tax lien, is whether and to what extent the taxpayer had 'property' or 'rights to property' to which the tax lien could attach. In answering that question, both federal and state courts must look to state law, for it has long been the rule that in the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayer had in the 'property' sought to be reached by the statute."

*Aquilino v. United States,* 80 S. Ct. 1277, 1280;

*United States v. Durham Lumber Company,* 80 S. Ct. 1282.

Apparently, the United States first agrees that state law determines the nature and extent of the "property" and "rights to property" to which its tax liens attach (U. S. Br. 7), though it fails to indicate any appropriate state court decisions either defining the property interests assertedly held by Appellant as of June 1, 1953 or contradicting the authorities cited by Appellant. Then, rather inconsistently, the United States seems to argue that Section 3710 of the Internal Revenue Act of 1939 creates those rights to which its lien attaches. (U. S. Br. 13, footnote 5.)

Neither Section 3692 nor Section 3710 of the Internal Revenue Act of 1939 creates property rights. Said sections merely attach federally defined consequences to rights created under state law. *Aquilino v. United States, supra; United States v. Durham Lumber Company, supra.*

The transaction between Appellant and the Remmers, having been made in California and being of the purchase money variety [Tr. of R. 31] precluded any debtor-creditor relationship between the parties, Section 580(b), California Code of Civil Procedure, and left the Remmers with a security interest only in the land to the extent of the unpaid balance. *Jeanese v. Surety Title and Guaranty Co.,* 176 Cal. App. 2d 449.

While the United States indicates that provisions of state law are irrelevant to a determination of the instant controversy (U. S. Br. 13, footnote 5), it argues, should state law be considered, that since a part of the Cal-Neva Lodge was located in Nevada, Nevada became the place of performance and that therefore its law must be held to govern the nature of the "proper-

ty" or "rights to property" of the Remmers held by Appellant on June 1, 1953. (U. S. Br. 13, footnote 5.)

The agreement between Appellant and the Remmers for the purchase of the Cal-Neva Lodge was entered into in the State of California. [Tr. of R. 31.] Further, a part of the Cal-Neva Lodge was located in the state of California. [Tr. of R. 31.] Whether Appellant was indebted to the Remmers as of June 1, 1953 is a matter of contractual interpretation as implemented by legislative enactment and does not in any manner involve the question of the validity of the Remmer deed of trust. Where a trust deed is utilized to secure a note obligation, borrower and lender impliedly contract that the land will constitute the primary fund to secure the debt and that a valid sale under the deed of trust must first be accomplished before any action can be maintained on the note. *Bank of Italy v. Bentley,* 217 Cal. 644.

"Questions relating distinctively and directly to the mortgage as distinguished from the personal obligation are to be referred to the Lex Rei Sitae as such, while those that relate primarily and distinctively to the personal obligation and only indirectly affect the mortgage may be governed by another law." 11 Am. Jur., Section 39. "It is a familiar rule that the construction and validity of the contract is governed by the rule of the place where it was made. . . ." 11 Am. Jur., Section 117. It would follow therefore that California law must determine what, if any, "property" or "rights to property" of the Remmers were held by Appellant on June 1, 1953.

Assuming, *arguendo,* that Nevada law controls in determining the nature of the "property" or "rights to property" held by Appellant on June 1, 1953, it should be noted that Nevada has a statute (Nevada Revised Statutes 40.430) providing for judicial foreclosure as a condition precedent to the granting of a deficiency judgment, *Walker v. Shrakes,* 339 P. 2d 124; *Nevada-Douglas Consolidated Copper Co. v. Berryhill,* 75 P. 2d 992, which said statute was copied from Section 726 of the California Code of Civil Procedure. VII American Law of Property, Section 16.201, footnote 1. Due to the scarcity of reported Nevada decisions, California authorities interpreting Section 726, California Code of Civil Procedure, would appear to be helpful in determining the force and effect of N. R. S. 40.430.

Section 726, California Code of Civil Procedure, constitutes an expression of the public policy of the state of California and accordingly, the provisions thereof may not be waived in advance by agreement between borrower and lender. *Winklemen v. Sides,* 31 Cal. App. 2d 387. The provisions of Section 726, California Code of Civil Procedure, may not be circumvented by a beneficiary of a trust deed through the device of his waiving his security and proceeding independently on the debt. *Western Fuel Co. v. Lewald,* 190 Cal. 25.

In *Meyer v. Weber,* 133 Cal. 681, the Supreme Court of the state of California, in describing the relationship between borrower and lender as affected by Section 726, California Code of Civil Procedure, stated at pages 684-685 as follows:

> "Whatever the sum of the debt, the mortgagor can be legally compelled to pay no part of it until the decree is entered for the sale of the premises

> mortgaged, and the liability which shall then accrue to him is a liability to pay only a deficiency which shall appear on the Sheriff's return. The liability is therefore contingent and dependent upon the fact whether upon the sale of the mortgaged premises there shall be a deficiency."

In *Birkhofer v. Krumm,* 4 Cal. App. 2d 43, the court was confronted with a situation somewhat similar to that present in the instant case. Grigsby borrowed money from Attwood and secured the obligation with a trust deed on certain real property. Thereafter Grigsby conveyed the real property subject to the trust deed to Krumm who agreed to assume the Attwood obligation. In analyzing the relationship between Grigsby, the trustor-grantor, Krumm, the grantee, and the secured creditor in the context of Section 726, California Code of Civil Procedure, the court, at page 50, stated as follows:

> "That the land furnishes the principal or primary fund for the payment of the mortgage debt; that as between the grantor and grantee, the grantee becomes the principal and the grantor the surety for the deficiency remaining after applying the money derived from the sale of the land on the debt; that from the point of view of the mortgagee both the grantor and the grantee stand in the relation of sureties for the payment of the deficiency to the mortgagee."

Notwithstanding the nature of Sections 726, California Code of Civil Procedure, and N. R. S. 40.430, and in spite of the fact that Section 580(b), California Code of Civil Procedure, precludes a debtor-creditor re-

lationship between borrower and lender in a purchase money situation, *Jeanese v. Surety Title and Guaranty Co., supra*, the United States contends that the aforementioned statutes are procedural only. (U. S. Br. 13.) To support its contention the United States cites the case of *United States v. Manufacturers Trust Co.*, 198 F. 2d 366. (U. S. Br. 17.)

In *Manufacturers Trust Co.* the court held that in levying upon the account of its tax debtor in the hands of defendant bank, the United States was not barred from collecting the proceeds in said account by its failure to present the bank with its tax debtor's passbook. In so holding, the court, at page 369, described the bank's contractual right to have the passbook presented before making payment as ". . . but a banking convenience to facilitate the identification of persons who were presently entitled to withdraw from the account. . . ."

A fact situation similar to that present in *Manufacturers Trust Co.* was before the court in *United States v. Emigrant Industrial Savings Bank,* 122 Fed. Supp. 547. The court, though holding for the United States, stated at page 549-550 as follows:

> "Conceivably a state statute might declare that to the extent that passbooks were not presented there should be no relation of debtor and creditor between bank and depositor. I think that that would affect the right itself and thus bind the government."

The attempt to equate the disregarding of the passbook requirement with the dispensing of the statutory protection accorded a debtor by Sections 580(b) and

726 of the California Code of Civil Procedure and N. R. S. Section 40.430 is unconscionable.

The United States points to the Referee's Finding of Fact VI to the effect that Appellant was indebted to the Remmers in the sum of $198,333.34 as of June 1, 1953 as establishing a debtor—creditor relationship. (U. S. Br. 11-12.) However, the United States ignores the Referee's Findings of Fact V and VII relating to the purchase money trust deed given the Remmers and the failure of both the Remmers and the United States to exhaust the security of said trust deed. [Tr. of R. 31-32.]

Courts have recognized the ineffectiveness of a levy by the United States where the liability of the person levied upon to the tax debtor is contingent upon the performance of a prior condition as would be the case in Nevada in the absence of a judicial foreclosure and deficiency judgment under Section 40.430 N. R. S. *Meyer v. Weber, supra.*

In *United States v. Chapman* (C. A. 10), 281 F. 2d 862, the owner of the realty was in possession of funds payable to the tax debtor as prime contractor. The tax debtor had failed to pay various labor and material claimants. By contract between the owner and tax debtor, the owner was authorized to retain the balance of funds until such time as tax debtor could furnish the owner proof of payment of the labor and material claimants. Such proof was a condition precedent to the right of the tax debtor to receive the retained balance. The court held that the tax debtor, having failed to satisfy the condition precedent, had no enforceable right to collect the retained balance and that accordingly there was no "property" or "rights

to property" to which the tax lien of the United States attached.

In *United States v. Massachusetts Mutual Life Insurance Co.* (C. A. 1), 127 F. 2d 880, the contract between the insurance company and the tax debtor, as the insured, provided that the tax debtor would have to first surrender his insurance policy before he could recover the cash surrender value of same. The United States, in levying upon the insurance company for the cash surrender value, failed to surrender the policy of insurance. The court held that the United States seized nothing by its levy for the reason that it failed to surrender the insurance policy, which said surrender was a condition precedent to liability and not a mere formality which could be dispensed with. See also *City of New York v. United States* (C. A. 2), 283 F. 2d 829; *In re Halperin* (C. A. 2), 280 F. 2d 407.

In addition to and by virtue of the failure of the United States to satisfy the condition precedent of Section 40.430 N. R. S., the United States is confronted with a further problem in attempting to sustain its levy of June 1, 1953. If there was any liability owing by Appellant to the Remmers as of June 1, 1953, the precise amount of that liability was unascertained as of the date of levy. *Meyer v. Weber, supra.* In *United States v. Stockyards Bank of Louisville* (C. A. 6), 231 F. 2d 638, the government levied upon its tax debtor's interest in various United States savings bonds held by the defendant bank. The bonds in question were owned jointly by the tax debtor and his wife. The respective interests of the tax debtor and his wife in and to the bonds in question were unascertained as of the date of levy. In holding that the bank was not

liable to the United States under Section 3710(b) of the Internal Revenue Act of 1939, the court stated at page 631, as follows:

> "Beyond showing that it was the delinquent tax payer who had left the bonds with the president of the appellee bank, the government adduced no evidence to establish the extent, if any, of his property interest in them. Proof of the actual value of the tax payer's interest was an essential element of the government's case under the statute, and for lack of such proof the case falls."

*In the Matter of Cherry Valley Homes, Inc.,* 255 F. 2d 706, cited by the United States (U. S. Br. 18, 19), is readily distinguishable from the instant controversy. In *Cherry Valley* there was no quarrel with the fact that the seizure by the United States found Cherry Valley in possession of an indebtedness owing to Tobin, the tax debtor. *Cherry Valley* merely stands for the proposition that while the debt owing to Tobin by Cherry Valley was not entitled to a bankruptcy priority, the appropriation of said debt by the United States converted the obligation of Cherry Valley into a claim entitled to priority in the subsequent bankruptcy of Cherry Valley.

The United States argues that in addition to its alleged indebtedness, Appellant was in possession of other "property" or "rights to property" of the Remmers as of June 1, 1953. (U. S. Br. 14.) It is correct that at the time of levy, Appellant had in its possession and was using in its business the Cal-Neva Lodge property. However, as of June 1, 1953 title to the Cal-Neva Lodge was in Appellant. [Tr. of R. p. 31.]

Accordingly, the Cal-Neva Lodge itself did not constitute "property" of the Remmers as of June 1, 1953.

The only things had by the Remmers which related to Appellant as of June 1, 1953, were the note and trust deed of December 31, 1948 [Tr. of R. 31], and a security interest in the land measured by the balance due as of June 1, 1953. *Jeanese v. Surety Title and Guaranty Co., supra.*

Certainly the note and trust deed of December 31, 1948 were not property in the possession of Appellant as of June 1, 1953.

> ". . . (I)t would be nonsense to say that a promissor is in 'possession' of a 'right to property' against himself, or that by performing he surrenders that right." *United States v. Metropolitan Life Insurance Co.* (C. A. 2), 130 F. 2d 149.

Assuming that Appellant could be said to have been in possession of the security interest of the Remmers in and to the Cal-Neva Lodge property as of June 1, 1953, can the Government seriously contend that it was the duty of Appellant to in some manner carve out approximately $200,000.00 worth of the Cal-Neva Lodge and turn same over to the United States?

> "Where the value and nature of the taxpayer's property rights are not in question, distraint is no doubt a useful tool in the effective enforcement of the Internal Revenue laws. But it is a blunt instrument, ill-adapted to carve out property interests where their nature and extent are unclear." *United States v. Stockyards Bank of Louisville, supra,* at page 631.

## II.

## The Claim of the United States Against Cal-Neva Lodge, Inc., Under Section 3710(b) of the Internal Revenue Code of 1939 Is a Penalty and Must Be Disallowed Pursuant to the Provisions of Section 57j of the Bankruptcy Act.

Appellant has heretofore argued that the imposition of liability against it under Section 3710(b) of the Internal Revenue Act of 1939 is penal and must fall pursuant to Section 57j of the Bankruptcy Act. (Op. Br. 10-12.) The United States, in its brief (U. S Br. 22) cites *United States v. Eiland,* 223 F. 2d 118, as standing for the proposition that payment to the Government pursuant to levy and notice constitutes a complete defense to the debtor against any action brought against him on account of the debt. In *Eiland,* the payment to which the court refers is payment made pursuant to a levy under Section 3692 of the Internal Revenue Act of 1939. The instant claim asserted by the United States against Appellant is not based upon Section 3692, but, rather, is made under the provisions of Section 3710(b).

> "Section 3710(b) is entirely a penal statute directed against persons who refuse to surrender property to the Collector as required by Section 3710(a), and accordingly no other parties are necessary to the suit. . . . The fact that the bank may be subject to double liability is no defense because Section 3710(a) permits only two defenses, to wit, that the said person is not in possession of property of the taxpayer which is subject to distraint, or that the property is subject to a prior

judicial attachment or execution." *United States v. Third National Bank & Trust Co.*, 111 Fed. Supp. 152, 156.

In *United States v. Stockyards Bank of Louisville, supra,* the court in describing the nature of an action under Section 3710(b), stated at page 630 as follows:

> ". . . (T)he proceeding authorized is not an action in Rem, nor is it a suit for the collection of a tax. It is a suit to enforce personal liability for failure to surrender property belonging to a delinquent taxpayer."

See also *United States v. Massachusetts Mutual Life Insurance Co., supra,* and *United States v. Aetna Life Insurance Co. of Hartford, Conn.,* 46 Fed. Supp. 30, to the effect that payment under Section 3710(b) constitutes no assurance to the person so paying that he will not be subject to a further action on the claimed indebtedness by the tax debtor to whom he was primarily indebted.

The cases of *Simonson v. Granquist* (C. A. 9), 1961-1 U. S. T. C. Par. 9226 and *United States v. Harris* (C. A. 9), 1961-1 U. S. T. C. Par. 9227 cited by the United States (U. S. Br. 23) are not in point in that they relate only to the allowance in bankruptcy of penalties on a non-penal lien claim of the United States. It is Appellant's contention that the claim of the United States involved herein is penal in its entirety.

The fact that the United States has chosen to apply any moneys which it may receive from Appellant or Park Lake Enterprises, Inc. to reduce the tax indebtedness of the Remmers (U. S. Br. 11, footnote 4, 22), can not be held to change the nature of Section 3710(b).

It is under this section that the United States asserts its claim against Appellant and, accordingly, the penal or non-penal nature of the claim of the United States must stand or fall upon the interpretation of said section.

## Conclusion.

Wherefore, Appellant prays:

1. That the Order of the District Court, dated June 27, 1960, sustaining the levy of the United States of June 1, 1953 be reversed.

2. That the Order of the Referee, dated April 18, 1959, be affirmed.

3. That Appellant recover of Appellee its costs on appeal.

Respectfully submitted,

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## APPENDIX.

### Additional Statutes Involved.

Section 40.430, Nevada Revised Statute.

"There shall be but one action for the recovery of any debt, or for the enforcement of any right secured by mortgage or lien upon real estate, or personal property, which action shall be in accordance with the provisions of N. R. S. 40.430, 40.440 and 40.450. In such action, the judgment shall be rendered for the amount found due the plaintiff, and the court shall have power, by its decree or judgment, to direct a sale of the encumbered property, or such part thereof as shall be necessary, and apply the proceeds of the sale to the payment of the costs and expenses of the sale, the costs of the suit, and the amount due to the plaintiff. . . . If it shall appear from the sheriff's return that there is a deficiency of such proceeds and balance still due to the plaintiff, the judgment shall then be docketed for such balance against the defendant or defendants personally liable for the debts, and shall, from the time of such docketing, be a lien upon the real estate of the judgment debtor, and an execution may thereupon be issued by the clerk of the court, in like manner and form as upon other judgments, to collect such balance or deficiency from the property of the judgment debotor."

Section 40.440, Nevada Revised Statute.

"If there be surplus money remaining after payment of the amount due on the mortgage, lien or encumbrance, with costs, the court may cause the same to be paid to the person entitled to it, and in the meantime may direct it to be deposited in court."

Section 40.450, Nevada Revised Statute.

"If the debt for which the mortgage, lien or encumbrance is held be not all due, so soon as sufficient of the property has been sold to pay the amount due, with costs, the sale shall cease; and afterwards, as often as more becomes due for principal or interests, the court may, on motion, order more to be sold. But if the property cannot be sold in portions without injury to the parties, the whole may be ordered to be sold in the first instance, and the entire debt and costs paid, there being a rebate of interest where such rebate is proper."